DOCKET SECTION

OFFICIAL TRANSCRIPT OF PROCEEDINGS BEFORE THE POSTAL RATE COMMISSION

In the Matter of:

RATE AND SERVICE CHANGES TO IMPLEMENT BASELINE NEGOTIATED SERVICE AGREEMENT WITH WASHINGTON MUTUAL BANK

Docket No. MC2006-3

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2006 NOV 14 P 3:12
POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

VOLUME #5

Date: November 13, 2006

Place: Washington, D.C.

Pages: 406 through 461

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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Rate and Service Changes to
Implement Baseline Negotiated
Service Agreeement with
Washington Mutual Bank

Docket No. MC2006-3

DESIGNATION OF WRITTEN CROSS-EXAMINATION

Interrogatories

Office of the Consumer Advocate

James F. Callow (OCA-T-1)

Postal Rate Commission	USPSIOCA-TI-6, 13, 15-16, 25 WMBIOCA-TI-6
United States Postal Service	USPS/OCA-T1-1-5, 7-12, 14, **17-24**
Washington Mutual Bank	WMBIOCA-TI-1-5

Respectfully submitted,

Steven W. Williams
Secretary

INTERROGATORY RESPONSES
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory	Designating Parties
Office of the Consumer Advocate	
James F. Callow **(OCA-T-I)**	
USPS/OCA-T1-1	USPS
USPS/OCA-T1-2	USPS
USPS/OCA-T1-3	USPS
USPS/OCA-T1-4	USPS
USPS/OCA-T1-5	USPS
USPS/OCA-T1-6	PRC
USPS/OCA-T1-7	USPS
USPS/OCA-T1-8	USPS
USPS/OCA-T1-9	USPS
USPS/OCA-T1-10	USPS
USPS/OCA-T1-11	USPS
USPS/OCA-T1-12	USPS
USPS/OCA-T1-13	PRC
USPS/OCA-T1-14	USPS
USPS/OCA-T1-15	PRC
USPS/OCA-T1-16	PRC
USPS/OCA-T1-17	USPS
USPS/OCA-T1-18	USPS
USPS/OCA-T1-19	USPS
USPS/OCA-T1-20	USPS
USPS/OCA-T1-21	USPS
USPS/OCA-T1-22	USPS
USPS/OCA-T1-23	USPS
USPS/OCA-T1-24	USPS
USPS/OCA-T1-25	PRC
WMB/OCA-T1-1	WMB
WMB/OCA-T1-2	WMB
WMB/OCA-T1-3	WMB
WMB/OCA-T1-4	WMB
WMB/OCA-T1-5	WMB
WMB/OCA-T1-6	PRC

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-1-4

USPSIOCA-TI-**1.**

Please refer to page 9, lines 7 and **8,** of your testimony. You state that "the Washington Mutual NSA, unlike previously proposed or recommended NSAs, permits unlimited discounts."

(a) Please confirm that the term "unlimited discounts" refers to the fact that the Washington Mutual NSA contains no cap or stop loss mechanism in relation to the declining block rate discounts Washington Mutual is eligible to receive. If you cannot confirm, please explain.

(b) Please confirm that the NSAs with Capital One, Bank One, and HSBC. as proposed by the Postal Service, did not contain stop loss caps.

RESPONSE TO USPS/OCA-T1-1

(a) Confirmed.

(b) Confirmed. I attempted to capture in a single phrase the fact that the Washington Mutual NSA differs from the "previously recommended Capital One, Bank One, and HSBC agreements, in which the Commission added a stop loss cap, as well as from the Discover and Bookspan NSAs, which were "previously proposed" (and subsequently recommended) with a stop loss cap.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-1-4

USPS/OCA-T1 -2.

Please refer to the appendix labeled "OCA-T-1_att1 -WMB.xls" that you included with your testimony. Cell D11 in the worksheet tabs labeled "Year 1," "Year 2," and "Year 3" contains the number -0.111483.

a) Please confirm that the source of this number is a coefficient in the multivariate regression model that USPS witness Thress used to forecast demand for First-Class Mail presort letters (Docket No. R2006-1).

b) If you cannot confirm, please explain

RESPONSE TO USPSIOCA-TI-2

(a) I can confirm that the source of the number -0.111483 is the testimony of Postal Service witness Thress (USPS-T-7), at Table 16, in Docket No. R2006-1.

(b) NA

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-1-4

USPS/OCA-T1-3

Please refer to page 3, lines 10 to 12, of your testimony. You state, "I accept Postal Service witness **Ayubs** assumption that Washington Mutual's entire discount induced First-class Mail solicitation letter volume is converted from Standard Mail."

a) In your judgment, does Washington Mutual's ability to convert its solicitation letter volume from Standard Mail to First-class Mail suggest that Washington Mutual regards First-class Mail as a close substitute for Standard Mail?

b) Do you agree with the proposition that by substituting a more expensive product (First-class Mail) for a less expensive product (Standard Mail), Washington Mutual expects the additional expense to be offset by a higher response rate to its First-class Mail solicitations? If no, please explain.

RESPONSE TO USPS/OCA-T1-3

(a) I have no way of knowing how Washington Mutual "regards" First-class Mail vis-a-vis Standard Mail. However, any mailer who voluntarily uses Firsr-Class Mail and Standard Mail for essentially the same purposes is behaving as if they are substitutes.

(b) I have no way of knowing what Washington Mutual "expects." However, any mailer who uses a more expensive input for marketing is behaving as if it believes that the substitution will more than pay for itself.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-1-4

USPS/OCA-T1-4

Please refer to page 12, lines 17 to 19, of your testimony. You state that "Washington Mutual receives discounts on all eligible First-class Mail solicitation letters exceeding the minimum discount threshold volume of 490 million mailpieces that are prompted for any reason, ensuring Washington Mutual a positive financial outcome."

a) In reaching this conclusion, did you consider whether Washington Mutual's negotiation and litigation costs associated with this NSA would have an effect on Washington Mutual's financial outcome? If yes, please provide the results of your analysis.

b) Do you agree that Washington Mutual's financial outcome under the NSA depends, in part, on the rate of customer responses it receives from its First-Class mail solicitations?

c) If Washington Mutual's solicitation letter volume is converted from Standard Mail to First-class Mail and the rate of customer responses it receives from its First-Class mail solicitations does not increase, will Washington Mutual's financial outcome necessarily be positive? If yes, please explain.

RESPONSE TO USPS/OCA-T1-4

(a) No. The purpose of my testimony was to propose a new financial model to estimate institutional contribution to the Postal Service, the regulated entity.

(b) – (c) Washington Mutual's financial outcome depends in part on customer response rate, as well as other exogenous factors, such as changes in corporate marketing plans. Thus, Washington Mutual's financial outcome may or may not be positive if the rate of customer responses "does not increase." Using the Panzar analysis, I have controlled for exogenous variables in order to estimate the volume response of Washington Mutual to changes in price.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-5-9

USPSIOCA-TI-5.

Please refer to page 25, lines 11 to 16, and page 26, lines 1 to 3, of your testimony where you estimate the USPS's investment costs, annual administrative costs, negotiation costs, and litigation costs associated with the Washington Mutual NSA.

(a) Please confirm that Washington Mutual Bank will incur similar costs associated with the NSA. If you cannot confirm, please explain.

(b) Have you attempted to estimate or quantify the costs of the NSA to Washington Mutual? If yes, please provide the results of your analysis.

RESPONSE TO USPSIOCA-TI-5

(a) I can confirm that Washington Mutual will incur similar types of costs. However, I do not know whether those costs will be similar in magnitude to the costs incurred by the Postal Service.

(b) No. The purpose of my testimony was to estimate the financial value of the agreement to the Postal Service, the regulated entity.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-5-9

USPS/OCA-T1-6.

Please refer to page 24, lines 17 to 19, of your testimony. You state that "if Washington Mutual mails First-class Mail solicitation letters exceeding 550 million, 549 million, and 548 million in Years 1, 2, and 3, respectively, the agreement is not worthwhile as a financial proposition."

a) Please confirm that the volume threshold you identify in your testimony for Year 1 of the Washington Mutual NSA is 550 million First-class Mail solicitation pieces. If you cannot confirm, please explain.

b) If Washington Mutual fails to mail more than 550 million Firs-Class Mail solicitation pieces during Year 1 of the agreement, can it be inferred that Washington Mutual will receive no benefit from the NSA? If no, please identify the benefits Washington Mutual may receive under the NSA if it fails to mail more than 550 million First-class Mail solicitation pieces during Year 1 of the agreement.

RESPONSE TO USPS/OCA-T1-6

(a) Not Confirmed. The volume threshold used in the Panzar analysis is 490 million—the same threshold used in the financial model of the Postal Service (see USPS-T-1 (Ayub), Appendix A (REV 6-7-06), Page 7). The volume figure of 550 million represents the volume at which the Postal Service will lose First-class Mail contribution in Year 1 of the agreement if Washington Mutual mails total First-class Mail solicitation letters exceeding 550 million.

(b) No. As shown in OCA-T-1, Attachment 1, if Washington Mutual "fails to mail more than 550 million First-class Mail solicitation pieces" (i.e., Washington Mutual mails First-class Mail solicitation letters greater than 490 million through 550 million) in Year 1 of the agreement, it will receive the "Total Mailer Discounts" in Column [4] associated with the "After Rates Volume (Actual)" shown in Column [2].

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-5-9

USPSIOCA-TI-7

Please refer to page 15, lines 14 to 16, of your testimony. You state, "I therefore apply the Panzar analysis to Washington Mutual's forecast volumes utilizing a price-difference, rather than an own-price, elasticity of demand."

a) Please explain the meaning of the term "price-difference elasticity" as you use it in your testimony.

b) Do you agree with the proposition that every individual mailer has a price-difference of elasticity demand of -0.1115? If no, please explain.

c) Did you consider or evaluate the Panzar test using different estimates of price-difference elasticity of demand? If yes, please provide the results of your analysis.

RESPONSE TO USPS/OCA-T1-7

(a) I use the term "price-difference" elasticity as an alternative for the term "discount" elasticity.

(b) No. The price-difference elasticity of -0.1115 is the average response for Standard Mail Regular letters converting to First-class Mail. As such, it is unlikely that any particular mailer would have a price-difference elasticity identical to the average.

(c) No.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-5-9

USPSIOCA-TI-8

Please refer to page 16, lines 8 and 9, of your testimony. You state that neither "the Postal Service nor Washington Mutual, however, supplied a price-difference (or own-price) elasticity specific to Washington Mutual in this proceeding."

a) Did you attempt to estimate Washington Mutual's cross-price elasticity? If yes, please provide the results of your analysis.

b) Did you consider how cross-price elasticity could be used in the development of the Panzar test? If yes, please provide the results of your analysis.

c) If you were to replicate your analysis under the Panzar test using the USPS's average own-price elasticity for First-class Mail and Standard Mail, what would be the results of your analysis?

RESPONSE TO USPSIOCA-TI-8

(a) – **(b)** No. **A** cross-price elasticity was not relevant **to** the development of the Panzar analysis presented in my testimony.

(c) The Postal Service's average own-price elasticity for First-class Mail workshared letters and Standard Mail letters were not relevant to the development of the Panzar analysis presented in my testimony. However, see my response to WMBIOCA-TI-(g), where I use the average First-class Mail workshared letters own-price elasticity (-0.129934) and the average price-difference elasticity (-0.111483) in the Panzar analysis.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-5-9

USPSIOCA-TI-9

Please refer to page 16, lines 10 to 12, of your testimony. You state, "I use the 'Average Standard Regular Letters Discount (relative to First-Classy developed by witness Thress (USPS-T-7) in Docket No. R2006-1."

a) Please explain why you decided to use the Average Standard Regular Letters Discount for developing the Panzar test.

b) Did you consider using the average First-class Mail and Standard Mail own-price elasticity and cross-price elasticity for developing the Panzar test? If yes, please provide the results of your analysis.

RESPONSE TO USPS/OCA-T1-9

(a) In response to OCA/USPS-T1-25(a) – **(c),** witness Ayub states that

the relevant elasticities are the own-price elasticity of WMB's First-class Mail and the elasticity of WMB's First-class Mail with respect to the discount between First-class Mail and Standard Mail (rather than the cross-price elasticity).

Witness Ayub further states, in response *to* OCA/USPS-T1-27, that "Using a discount elasticity[ ] similar to the one used by Witness Thress [USPS-T-7] in Docket No. R2006-1 to model shifts between First-class Presort mail and Standard Mail regular" results in the following equation:

$$Q_0 = Q_1 \cdot \left(\frac{p_0}{p_d}\right)^{E_p} \cdot \left(\frac{d_0}{d_d}\right)^{E_d}$$

where the term E, represents "discount elasticity."

However, I assume, like witness Ayub, that Washington Mutual's forecast after-rates volumes are to be derived entirely from the conversion of solicitation letters from Standard Mail to First-class Mail for purposes of estimating the financial value of the

agreement. As a result, witness Ayub subsequently confirms, in response to OCA/USPS-T1-29(c), that the form of the equation should be as follows

$$Q_0 = Q_1 \cdot 1 \cdot \left(\frac{d_0}{d_d}\right)^{E_d}$$

since he implicitly assumes an own-price elasticity of 0 for Washington Mutual's First-Class Mail volume.

Accordingly, the only relevant elasticity to be applied is the "discount elasticity," presented in Table **16** of witness Thress' testimony (USPS-T-7), which he identifies as the "Average Standard Regular Letters Discount (relative to First-Class)."

(b) No. According to witness Ayub, Washington Mutual's First-class Mail solicitation letters volume is to be derived entirely from the conversion of Standard Mail solicitation letters to First-class Mail. For purposes of estimating the financial value of the agreement, there is no other source for Washington Mutual's First-class Mail volume. Accordingly, I assume an own-price elasticity of C. Moreover, as indicated by witness Ayub, a cross-price elasticity is not relevant to the estimation of demand for Washington Mutual.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-10-16

USPS/OCA-T1-10.

Please refer to page 3, lines **2** to *5,* of your testimony. You state, "I propose application of an alternative financial model to the negotiated service agreement concluded between Washington Mutual Bank and the Postal Service, based upon the 'Panzar' analysis presented by the Commission in Docket No. MC2005-3."

a) In developing your Panzar model, did you rely on the framework and guidance presented in the Opinion and Further Recommended Decision of the Postal Rate Commission (PRC) in Docket No. MC2004-3?

b) Did you rely on any additional sources to develop your Panzar model? If yes, please identify those additional sources.

RESPONSE TO USPS/OCA-T1-10

(a) – (b). I relied on the framework and guidance presented in the Opinion and Further Recommended Decision in Docket No. **MC2004-3.** and additional sources, to the extent cited in my testimony.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-10-16

USPS/OCA-T1-11.

Please refer to page 26 of the PRCs Opinion and Further Recommended Decision in Docket No. MC2004-3 where it states, "The essence of the framework would be for the mailer and the Postal Service to establish a wide range of potential volumes that constituted the realistic bounds of what the mailer would send under the terms of the agreement (after-rates volumes). The proponents would negotiate a set of discounts that would demonstrably satisfy the Panzar inequality above for every possible after-rates volume within the range."

a) Please confirm that, according to the PRC's Opinion and Further Recommended Decision in Docket No. MC2004-3, the Panzar test requires the proponents to "establish a wide range of potential volumes that constituted the realistic bounds of what the mailer would send under the terms of the agreement (after-rates volumes)." If you cannot confirm, please explain.

b) In your judgment, what range of volumes would be considered "realistic" as you understand that term?

c) In developing your Panzar model, did you estimate or assume a range of volumes that would be sent under the Washington Mutual NSA? If yes, please state your estimations or assumptions.

d) In your opinion, is it possible to forecast future mail volumes without knowledge of future prices? If yes, please provide examples.

e) In your judgment, did Washington Mutual provide a "realistic" forecast of its before-rates and after-rates mail volumes in its testimony (WMB-T-1)?

RESPONSE TO USPS/OCA-T1-11

(a) Confirmed.

(b) As stated in PRC Op. MC2005-3, para. 5012, quoted in part a., above, the framework is to be used by "proponents" during negotiations to "establish a wide range of potential volumes." The difference between the framework and the "Panzar" analysis was described by the Commission in PRC Op. MC2005-3 (Bookspan), para. 4089, fn 110:

The Panzar analysis is not to be confused with the alternative approach model for designing declining block NSAs suggested by the Commission in its Opinion and Further Recommended Decision in MC2003-4, paras. 5001-38. The former is an analysis for evaluating the risk of loss, while the latter is a model for negotiating NSAs that uses the Panzar analysis in their design.

Since I am not participating in negotiating an NSA, I did not consider what range of volumes would be "realistic."

(c) **No.**

(d) Yes. A trend analysis has been used in the past by the Postal Service as "a relatively simple approach . . . to predict future movements in mail demand." Docket No. MC2004-3, Revised Declaration of Michael K. Plunkett (May 18, 2005), at 7.

(e) No. I estimated, and the Postal Service confirmed in response to OCA/USPS-T1-29(d), a "discount elasticity" of -0.8538 that was "backed-out" of Washington Mutual's stated before-rates and after-rates point volume estimates using the average revenue for First-Class marketing letters, the Standard Mail revenue per piece, and the highest negotiated discount—assuming Washington Mutual's own-price elasticity equals 0. This derived "discount elasticity" is more than 29 Standard Errors away from the "price difference" elasticity developed by witness Thress, calculated as follows: 29.0883 ((0.111483 − 0.85387166) / 0.033187)), where 0.111483 represents the absolute value of the "price difference" elasticity developed by witness Thress, 0.85387166 the absolute value of Washington Mutual's derived "discount elasticity," and 0.033187 the absolute value of the Standard Error developed by witness Thress.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-10-16

USPSIOCA-TI-12

Please refer to pages 24 to 27 of your testimony. On page 25, lines 4 and 5, of your testimony, you state, "I use net present value analysis io estimate the volume that would produce a return on investment equal to the Postal Service's 'cost of money.'"

a) Please confirm that you compared the net present value (NPV) of the Postal Service's costs to the absolute discounts paid to Washington Mutual *to* estimate the Postal Service's return on investment under the NSA. If you cannot confirm, please explain.

b) To estimate the Postal Service's return on investment under the NSA, did you also compare the NPV of the Postal Service's costs to the NPV value of discounts paid to Washington Mutual?

c) Isn't it true that the comparison described in subpart (b) would yield a more accurate estimate of the Postal Service's return on investment than would the comparison described in subpart (a)? If no, please explain.

RESPONSE TO USPS/OCA-T1-12

(a) Not confirmed. As explained in my testimony in the cited pages, I calculated whether the present values of cash inflows exceed present values of cash outflows discounted at the Postal Service's "cost of money." In the case of the Washington Mutual NSA, cash inflows to the Postal Service consist of "new" contribution, less any discounts "earned" by Washington Mutual. Cash outflows consist of investment expenses (e.g., negotiation and litigation costs), and annual administrative costs. At *544* million in Year 1, the Net Present Value is $49,302—indicating that cash inflows equal (approximately) cash outflows when discounted at the Postal Service's cost of money.

(b) Yes. See the response to part (a), above.

(c) Yes.

RESPONSES OF OCA WITNESS JAMES **F.** CALLOW
TO INTERROGATORIESUSPSIOCA-TI-10-16

USPS/OCA-T1-13

Please refer ***to*** pages 25 and 26 of your testimony. Using the costs you have estimated, please calculate the Postal Service's return on investment under the NSA if the agreement generated **the** following increases in cont.ibution in Year 1:

a) $1,000,000.

b) $2,000,000.

c) $5,000,000.

RESPONSE *TO* USPS/OCA-T1-13

The net present value analysis in my testimony is based upon cash inflows during the entire three-year period of the Washington Mutual NSA. For purposes of this response, I therefore assume cash inflows of $1 million for Years 1, 2, and 3 in response to part a); $2 million for each year in response **to** part b): and, $5 million for each year in response ***to*** part c). I also assume the cash outflows (i.e., negotiation, litigation, and annual administrative costs), and **the** discount rates of the net present value analysis remain the same.

(a) The net present value is: $2,155,116.

(b) The net present value is: $4,853,409.

(c) The net present value is: $12,946,849.

RESPONSES OF OCA WITNESS JAMES **F.** CALLOW
TO INTERROGATORIES USPSIOCA-TI-10-16

USPS/OCA-T1-14

Please refer to page 11, line 10, of your testimony, where you state that, "Washington Mutual's volume estimates are not subject to replication."

a) Have you attempted to develop independent forecasts of Washington Mutual's before-rates mail volume? If yes, please provide the results of your analysis.

b) Have you attempted to identify exogenous factors that could cause an increase in the before-rates volume?

c) If your answer to subpart (b) is yes, have you attempted to model the impact of these factors on the before-rates and after-rates mail volume? If no, please explain why you have not attempted to do **so.**

d) Assume that an exogenous factor leads to increased mail volumes. Isn't it true that Washington Mutual would have to spend more money on postage to mail those volumes through the USPS? If no, please explain.

RESPONSE TO USPSIOCA-TI-14

(a) No.

(b) Yes. See my testimony at page 10, lines 1-4.

(c) No. I did not develop a model of Washington Mutual's deman for First-Class Mail solicitation letters to estimate the effect of exogenous factors on Washington Mutual's before-rates and after-rates volume.

(d) Yes. In the context of the Washington Mutual NSA, an exogenous factor (or factors) that increased solicitation letters volume would increase postage revenues to the Postal Service. However, based on the conditions assumed, such an increase in postage would occur with or without the NSA, resulting in the Postal Service receiving an increase in institutional contribution, but not from the NSA.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS IOCA-TI-10-16

USPS/OCA-T1-15

Please refer to page 7, lines 1 to 5, of your testimony. You state, "An essential requirement of any negotiated service agreement is mutual financial gain for both the Postal Service and the potential NSA partner. Mutual gain arises where the agreement generates additional contribution for the Postal Service resulting from the entry of additional mail in response to discounted rates offered to the participating mailer." Additionally, please refer to page 7, lines 21 and 22, and page 8, line 1, of your testimony. You state, "A 'win-win' outcome for the Postal Service and the participating mailer is also essential to reduce the risk of harm to mailers not party to the agreement, especially where such mailers are dependent on the monopoly services of the Postal Service."

a) Assume that under this NSA Washington Mutual converts all of its Standard Mail volume to First-class Mail resulting in $10 million of increased contribution to the Postal Service.
   I. In your opinion, would Washington Mutual's increased contribution under the NSA benefit the Postal Service? If no, please explain.
   II. In your opinion, would Washington Mutual's increased contribution under the NSA benefit other mailers not party to the agreement? If no, please explain.

b) Additionally, assume that the Postal Service did not enter into this NSA with Washington Mutual. Do you agree with the proposition that the opportunity cost of not pursuing this agreement with Washington Mutual is $10 million? If no, please explain.

c) In your opinion, would the Postal Service be in a better financial position under the hypothetical presented in subpart (a) or under the hypothetical presented in subpart (b)? If no, please explain.

d) In your opinion, would other mailers not party to the agreement be in a better financial position under the hypothetical presented in subpart (a) or under the hypothetical presented in subpart (b)? If no, please explain.

RESPONSE TO USPS/OCA-T1-15

(a) – (d) I don't know. Washington Mutual may convert its Standard Mail to First-class Mail because of exogenous factors, with or without the NSA.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIESUSPS/OCA-T1-10-16

USPS/OCA-T1-16

Please refer to page 28, lines **2** to 6, of your testimony. You state in part, "This expected contribution is sufficient to recover the Postal Service's investment in the Washington Mutual NSA, and provide a meaningful contribution to institutional costs."

a) Please explain what you mean by the phrase "meaningful contribution to institutional costs" as you use it in your testimony.

b) Have you identified a minimum absolute value of increased contribution that will "provide a meaningful contribution to institutional costs"? If yes, please provide the analysis used to develop this number.

RESPONSE TO USPS/OCA-T1-16

(a) I define the phrase "meaningful contribution" to mean institutional contribution to the Postal Service significantly greater than $0.

(b) Yes. At a volume of 521 million, the estimated financial benefit to Washington Mutual approximates the expected contribution received by the Postal Service during the three-year period of the agreement. The Postal Service's expected contribution is $3.453 million, while Washington Mutual 'earns" discounts of $3.510 million. See my testimony at pages 27-28. At this volume. contribution to the Postal Service is approximately 100 percent, i.e., 98.4 percent ($3.454 / $3.510) of Washington Mutual's discounts, and therefore provides a "meaningful contribution to institutional costs."

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-17-18

USPS/OCA-T1-17.

On page **24,** lines **22** to **24,** of your testimony, you state, "The Panzar analysis does not consider the Postal Service's.. .costs of litigation to obtain regulatory approval."

a) To your knowledge, has the Postal Rate Commission ever considered a party's costs of litigation to obtain regulatory approval in a rate and classification proceeding? If yes, please provide examples.

b) Please confirm that, as a general matter, the USPS's NSA litigation and negotiation costs are likely to increase when an intervenor files testimony. If you cannot confirm, please explain.

c) Please confirm that, as a general matter, the USPS's NSA litigation and negotiation costs are likely to increase when the Commission alters the terms of the NSA. If you cannot confirm, please explain.

RESPONSE TO USPS/OCA-T1-17.

(a) Not to my knowledge. That said, while a negotiated service agreement is presented in a mail classification proceeding, it is not a "typical" mail classification. In a "typical" mail classification proceeding, the Postal Service proposes a cost coverage that includes a reasonable contribution to institutional costs based upon the rates and fees in its request to the Commission. Under such circumstances, litigation costs are considered at least indirectly by the Commission in determining the appropriate cost coverage. Unlike "typical" mail classification proceedings, however, the Postal Service does not propose a cost coverage based upon the discounted rates contained in a negotiated service agreement. To date, negotiated rates have simply been required to generate an estimated increase in institutional contribution to the Postal Service greater than $0 for the agreement as a whole. The net present value analysis I propose attempts to establish a reasonable basis for estimating at what point the Washington

Mutual **NSA** will make a reasonable contribution to the institutional costs of the Postal Service. As suggested by the Commission in PRC Op. MC2005, paras. **4014,** fn 50, and **4015,** fn **51, I** propose a positive return on the **Postal** Service's investment at least equal to the Postal Service's "cost of money."

(b) – (c) In general, litigation expenses are likely to increase in response to intervenor testimony or Commission action. However, litigation associated with active participation by an intervenor or Commission action is a cost to obtain regulatory approval and, as such, that cost should be included in any estimate of litigation expenses. By contrast, negotiation expenses would be relatively fixed in amount as they are associated with developing and concluding an agreement, and for the most part occur prior to litigation before the Commission.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-18

USPS/OCA-T1-18.

Please refer to page 25, lines 15 and 16, and page 26, line 1, of your testimony. You state, "I estimate the Postal Service's investment in negotiating and litigating the Washington Mutual NSA at $250,000 each ... or $500,000."

a) Please provide the quantitative analysis on which you relied to develop this estimate.

b) Please confirm that you used either the penalty figure from section II(J) of the Washington Mutual NSA ("Solicitation Mail Volume Guarantee") or the penalty figure from section III(D) of the agreement as a proxy for your estimate of the USPS's costs for negotiating and litigating the agreement. If you cannot confirm, please explain.

c) Please confirm that, to your knowledge, the USPS has never represented that either of the penalty figures referenced in subpart (b) serves as a proxy for the USPS's costs for negotiating and litigating the agreement. If you cannot confirm. please explain.

RESPONSE TO USPS/OCA-T1-18.

(a) See my response to WMB/OCA-T1-4(a) – (D) for the basis of my estimate of the costs of negotiation. See my response to part (c), below, for the basis of my estimate of litigation costs.

(b) Confirmed, for the Postal Service's costs of litigation.

(c) I interpreted the testimony of witness Ayub on oral cross-examination to mean the litigation costs of the Postal Service:

> I think [the transaction penalty cost of $250,000] is supposed to cover the transaction costs of pursuing the NSAs. Tr. 2/184

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-19-25

USPS/OCA-T1-19.

Please refer to your response to USPSIOCA-TI -5, subpart (b), where you confirm that you have not attempted to quantify the cost of the NSA to Washington Mutual. Please also refer to page *7,* lines 9 to 10, of your testimony. You state, "An essential requirement of any negotiated service agreement is mutual financial gain for both the Postal Service and the potential NSA partner."

a) Please confirm that Washington Mutual Bank would benefit financially from the incentives the NSA will provide WMB for converting Standard Mail volume to First-class Mail.

b) In your judgment, is it possible to determine whether the WMB NSA will result in "mutual financial gain" to WMB and the Postal Service without attempting to quantify the costs of the agreement to WMB? If yes, please explain.

RESPONSE **TO** USPSIOCA-TI-19.

(a) Confirmed, assuming Washington Mutual enters "eligible" First-class Mail, as that term is defined under the NSA.

(b) Yes. Quantifying the financial gain to washington Mutual under the NSA has not been estimated by the Postal Service, or provided by Washington Mutual. Moreover, the Commission has not prepared, **or** required the Postal Service or NSA participants to provide, an estimate of financial gain. Nor in my judgment is it necessary in order to determine whether Washington Mutual will derive any financial gain. Since Washington Mutual can exit the agreement "without cause" at any time, expected financial gain to Washington Mutual is signified by its continued participation in this proceeding.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-19-25

USPSIOCA-TI-20.

Please refer to your response to USPSIOCA-TI-4, subparts (b) and (c). You state, "Washington Mutual's financial outcome may or may not be positive if the rate of customer responses 'does not increase.'" Please assume for the purpose of this interrogatory that the NSA induces WMB to shift 90 percent of its solicitation mail volume to First-class Mail from Standard Mail. Additionally, please assume that all other variables remain constant except for the rate of customer responses WMB receives from its First-class Mail solicitations.

a) If the customer response rate referenced above were to decrease or remain constant after WMB converts its Standard Mail volume to First-class Mail, could WMB experience a net positive financial outconie under the NSA?

b) If the answer *to* subpart (a) is "yes," please explain how WMB could experience a net positive financial outcome under the NSA.

c) Does the possibility that WMB's customer response rate might decrease under the NSA pose a financial risk to WMB?

d) If your answer is to subpart (c) is "no" please identify any risks you have identified for WMB under the NSA.

RESPONSE TO USPS/OCA-T1-20.

(a) - (b) The Postal Service has selected one exogenous factor—the response rate of customers receiving Washington Mutual's solicitation letters—and assumed that rate will decrease or remain constant for First-class Mail solicitation letters after implementation of the NSA. This is implausible in that the decrease in response rate is assumed to be present only after-rates, but not before-rates. Moreover, while customer response rates may differ as between First-class Mail and Standard Mail, any exogenous factor that affects the response rate of customers receiving First-class Mail solicitations will also affect the response rate of customers receiving Standard Mail solicitations in the same direction. Given the implausible nature of this interrogatory's

assumption, Washington Mutual is unlikely to experience a net positive financial outcome.

(c) - (d) The Postal Service's assumed risk—that the customer response rate might decrease—is not a financial risk inherent to or associated with an NSA. The risk that Washington Mutual (or the Postal Service) may misestimate the customer response rate, or the risk of any other exogenous factor, is always present and is independent of whether Washington Mutual participates in an NSA or not. Thus, the Commission's statement regarding risk is accurate:

> All risk related to volume forecasts used as the basis for unrestricted volume discounts is borne by the Postal Service and other mailers not party to the agreement. PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), para. 5007, fn 21.

Moreover, for purposes of estimating the financial value of the agreement, I explicitly controlled for the effects of exogenous factors before-rates and after-rates in developing the Panzar analysis. Doing so precludes manipulation of exogenous factors to produce a desired or intended outcome, such as an assumption of the presence of exogenous factors after-rates, or the lack thereof, that differs from before-rates, or vice versa. As a result, the Panzar analysis produces an estimate of financial value that is based an volumes attributable to the discounted rates, rather than to exogenous factors. The Postal Service's hypothetical is not a *ceteris* paribus assumption, since the customer response rate is assumed relatively unfavorable to Washington Mutual after-rates, but relatively favorable before-rates.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-19-25

USPS/OCA-T1-21.

Please refer to your response to USPSIOCA-TI -8, subparts (a)-(b), where you state that "A cross-price elasticity was not relevant to the development of the Panzar analysis presented in my testimony."

a) Please define the term "cross-price elasticity" as you understand it.

b) For the purpose of this subpart, please assume that the Postal Service does not enter into an NSA with WMB and that all exogenous factors and postage prices remain constant. Additionally, please assume that WMB converts its Standard Mail volume to First-class Mail at the rate identified in the original filing. Please calculate the resulting cross-price elasticity and explain how you reached your result.

c) For the purpose of this subpart, please assume that the Postal Service does not enter into an NSA with WMB and that all exogenous factors and postage prices remain constant. Additionally, please assume that WMB converts its Standard Mail volume to First-class Mail at the rate identified in the original filing. Please confirm that a calculation of cross-price elasticity would be essential to an evaluation of WMB's mailing preferences. If you cannot confirm, please explain.

RESPONSE TO USPSIOCA-TI-21

(a) A "cross-price" elasticity, or a cross elasticity of demand, "measures how sensitive [] purchases of *one* product (say X) are to a change in the price of some other product (say Y)." (Emphasis original). McConnell, Carnobell R., *Economics* (10th Ed., 1987), 502. In general terms, a cross elasticity of demand can be described as follows:

$$E_{xy} = \frac{\text{Percentage Change in Quantity Demanded of X}}{\text{Percentage Change in Price of Y}}$$

More specifically, the cross-elasticity of demand is "the percentage change in the quantity of *X* purchased resulting from a 1 percent change in the price of *Y*." Ferguson,

C. E., *Microeconomic Theory,* (1969), 86. Thus, the cross-elasticity of demand can be defined as:

$$E_{xy} = \frac{\Delta q_x}{q_x} \div \frac{\Delta p_y}{p_y}$$

where E_{xy} is the cross elasticity of demand for product x with respect to a change in price of product y, Δq_x is the change in the quantity of x, and Δp_y is the change in the price of y.

(b) – (c) The purpose of my testimony is to estimate the financial value of the Washington Mutual NSA to the Postal Service, The hypothetical is unrelated to my testimony in that it requests the calculation of a cross elasticity under circumstances where there is no agreement. Specifically, the hypothetical assumes "the Postal Service does not enter into an NSA with WMB and that *all* . . . postage prices remain constant." (Emphasis added).

In order to estimate the financial value of the agreement, I did not consider the possibility of no agreement. Nor did I calculate a cross elasticity, or consider the role of such an elasticity in any evaluation of Washington Mutual's mailing preferences. In addition, as stated previously, a cross elasticity is not relevant to the development of the Panzar analysis in my testimony.

Moreover, the hypothetical cannot be answered as posited. Given the absence ***of*** any change in the price of First-class Mail or Standard Mail, as stated in the hypothetical, the requested cross elasticity cannot be derived because the definition of a cross elasticity (see part (a), above) requires a change in price.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-19-25

USPS/OCA-T1-22.

Please refer to your response to USPS/OCA-T1 -11, subpart (d), where you confirm that it is possible to forecast future mail volumes without knowledge of future prices. Additionally, you state that "A trend analysis has been used in the past by the Postal Service 'as a relatively simple approach...to predict future movements in mail demand.'"

a) Please confirm that it is your understanding that the Postal Service uses trend analysis to forecast before-rates or after-rates mail volume.

b) In your judgment, do you believe that a trend analysis which does not account for price changes can yield an accurate estimate of future mail volumes?

c) Is the price of postage an important factor in developing a forecast of demand?

d) To your knowledge, are there any other methodologies other than a trend analysis that would enable USPS or WMB to forecast future mail volume?

RESPONSE TO USPSIOCA-TI-22.

(a) Confirmed.

(b) In my judgment, a trend analysis that forecasts future mail volumes solely as a function of time does not account for price changes, and therefore cannot yield a reliable or accurate estimate of future mail volumes. The Postal Service apparently agrees, stating that "a simplified trend analysis ignores exogenous factors such as pricing changes, interest rates . . . competitors' strategies . . . and a host of other variables." Docket No. MC2004-3, Revised Declaration of Michael K. Plunkett (May 18, 2005), at *8.*

(c) Yes.

(d) I don't know. To the extent there are, I did not consider them, and they are not used in my testimony. That said, the use of price elasticities is one methodology I

am aware a that explicitly controls for the effects of *exogenous* variable in estimating future mail volumes. In my testimony, I used a pricedifference elasticity.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-19-25

USPS/OCA-T1-23.

Please refer to your response to USPS/OCA-T1 -11, subpart (e). Additionally, please refer to your response to USPSIOCA-TI-14. subpart (c) where you state, "I did not develop a model of Washington Mutual's demand for First- Class Mail solicitation letters to estimate the effects of exogenous factors on Washington Mutual's before-rates and after-rates volume."

a) Please confirm that your response to USPS/OCA-T1-11, subpart (e), is based solely on an evaluation of Washington Mutual's before-rates and after-rates volumes and the elasticities you identified in your response to USPS/OCA-T1 -11, subpart (e).

b) Please describe all factors other than the elasticities you identified in your answer to USPS/OCA-T1 -11, subpart (e), that support your negative response to USPS/OCA-T1-11, subpart (e).

c) Please identify the exogenous factor or factors that might cause WMB to shift its solicitation mail volume from Standard Mail to First-class Mail.

d) For the purpose of this subpart, please assume that the Postal Service does not enter into an NSA with WMB. For each factor identified in subpart (c) please describe how these factors would induce WMB to shift its solicitation mail volume from Standard Mail to First-class Mail.

e) Please confirm that you did not independently estimate the effect *of* exogenous factors on Washington Mutual's before-rates and after-rates mail volumes.

9 In your judgment, is it possible to estimate the impact a change in an exogenous factor would have on mail volume without also Estimating the effect of exogenous factors on before-rates and after-rates mail volumes? If your answer is yes, please explain.

RESPONSE TO USPS/OCA-T1-23.

(a) Confirmed.

(b) I considered none.

(c) In my testimony, I listed a few exogenous factors from an infinite number of possible factors that might cause a shift in Washington Mutual solicitation mail volume.

Probably the most important factors "include changes in corporate management, or changes in corporate financial goals or marketing strategies." See my testimony at page 10, lines 1-4.

(d) - (e) I did not independently model the effects of exogenous factors on Washington Mutual's mail volumes. Consequently, I do not know with certainty how Washington Mutual would respond to these exogenous factors. Nevertheless, whatever exogenous factors are identified, those factors will be present and affect Washington Mutual's mail volumes with or without the NSA. Most problematic for the Postal Service, however, would be a change in corporate marketing strategy in which Washington Mutual decided to shift its solicitation mail volume from Standard Mail to First-class Mail, and then concluded with the Postal Service a negotiated service agreement that featured discounted rates.

(f) No. As witness Ayub has testified, "If a variable causes a change in the before-rates forecast, holding all other factors equal, it should have a similar impact in the same direction on the after-rates forecast." Tr. 2/28 (OCA/USPS-T1-1(d)).

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-19-25

USPS/OCA-T1-24.

Please refer to your response to USPSIOCA-TI-15. subparts (a) - (d), where you state, "I don't know. Washington Mutual may convert its Standard Mail to First-class Mail because of exogenous factors, with or without the NSA." Please revise your responses to USPS/OCA-T1-15, subparts (a) - (d), assuming that all exogenous factors remain constant.

RESPONSE TO USPSIOCA-TI-24.

In my response to USPS/OCA-T1-15(a) - (d), I assumed that all exogenous factors remain constant because such factors are always present and may cause Washington Mutual to convert its Standard Mail to First-class Mail, "with or without the NSA." Thus, my answer remains the same.

Interrogatory USPS/OCA-T1-15(a) - (d) assumes that the Postal Service will automatically benefit from an NSA if, afler the agreement is implemented, there is a subsequent increase in mail volume. However, it cannst be assumed that because the Postal Service enters into an NSA with a mailer and volumes increase that the increase was caused by the NSA. In doing so, the Postal Service commits the well known logical fallacy post hoc ergo propter ***hoc.*** It is entirely possible that the increase in mail volume was caused by exogenous factors, which exist with or without the NSA. Moreover, increased contribution benefiting the Postal Service and mailers not party to the agreement, above what would be realized absent a NSA, occurs only where additional mail volume is caused by the incentive to mail additional volume (because of the mailer's demand characteristics), and not because of exogenous factors.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-19-25

USPSIOCA-TI-25.

Please refer to your response to USPS/OCA-T1-16, subpart (a), where you state, "I define the phrase 'meaningful contribution' to mean institutional contribution to the Postal Service significantly greater than $0." Please define the threshold for "significantly greater than $0."

RESPONSE TO USPS/OCA-T1-25.

At a "threshold" (i.e., volume) of 521 million during each year of the agreement, the resulting institutional contribution of $3.453 million would represent a 'meaningful contribution" to the Postal Service "significantly greater than $0." See my response *to* USPSIOCA-TI-16(b).

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMB/OCA-T1-1-4

WMB/OCA-T1-1.

Please refer to lines 6 through 12 on page 16 of your testimony where you state:

> Neither the Postal Service nor Washington Mutual, however, supplied a price-difference (or own-price) elasticity specific to Washington Mutual in this proceeding. In the absence of such a company-specific elasticity, I use the "Average Standard Regular Letter Discount (relative to First-class)" developed by witness Thress (USPS-T-7) in Docket No. R2006-1. That elasticity, estimated at -0.1115, serves by default as a proxy for Washington Mutual's elasticity of demand for Standard Mail with respect to the change in the price difference between First-class Mail and Standard Mail.

Please also refer to witness Ayub's response to OCA/USPS-T1-29(d) where he confirms that "if Washington Mutual's First-class mail volume had an own-price elasticity of demand equaling zero, the given equation could be solved as stated, within rounding" in response to OCA's calculation of a -.8538 "discount elasticity" for WMB's First-class Mail volume.

Further, please refer to page 18 of your testimony where you discuss the volume above which the Panzar analysis indicates that "the Postal Service will lose First-class Mail contribution in Year 1 of the agreement."

Finally, please refer to the elasticities for workshared First-class Mail presented on page 73 of witness Thress' testimony (USPS-T-7) in Docket No. R2006-1.

(a) Please confirm that the Panzar analysis presented in your testimony assumes that the own-price elasticity of demand of WMB's First-class Mail volume is zero. If not confirmed, please explain fully.

(b) Please confirm that the Panzar analysis presented in your testimony does not take into account any cost savings from the NSA. If not confirmed, please explain fully.

(c) Please confirm that the Panzar analysis in your testimony assumes that WMB's "price-difference elasticity" is equal to the average for workshared First-class Mail, but that its own-price elasticity is significantly less - zero - than the average for workshared First-class Mail. If not confirmed, please explain fully.

(d) Please confirm that the volume above which the Panzar analysis estimates "the Postal Service will lose First-class Mail contribution" would be higher than presented in your testimony if it used average elasticities (for workshared First-Class Mail) for both the price difference elasticity and the own-price elasticity. If not confirmed, please explain fully.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMB/OCA-T1-1-4

(e) Please confirm that the volume above which the Panzar analysis estimates "the Postal Service will lose First-class Mail contribution" would be higher than presented in your testimony if it used the price-difference elasticity of -.8538 that OCA calculated in OCA/USPS-T1-29(d) and an own-price elasticity of zero. If not confirmed, please explain fully.

(9 Please provide revisions to Figures 1, 2, and 3 of your testimony based upon a Panzar analysis that uses a price-difference elasticity of -.8538 and an own-price elasticity of zero. Please also provide all of your underlying calculations in an electronic spreadsheet format.

(g) Please provide revisions to Figures 1, 2, and 3 of your testimony based upon a Panzar analysis that uses the average price-difference and own-price elasticities for workshared First-class Mail. Please also provide all of your underlying calculations in an electronic spreadsheet format.

RESPONSE TO WMB/OCA-T1-1

(a) Confirmed.

(b) Confirmed. Consistent with the financial model of the Postal Service, I do not assume any cost savings from the provision of electronic address correction notices in lieu of physical returns in estimating the financial value of the Washington Mutual NSA using the Panzar analysis.

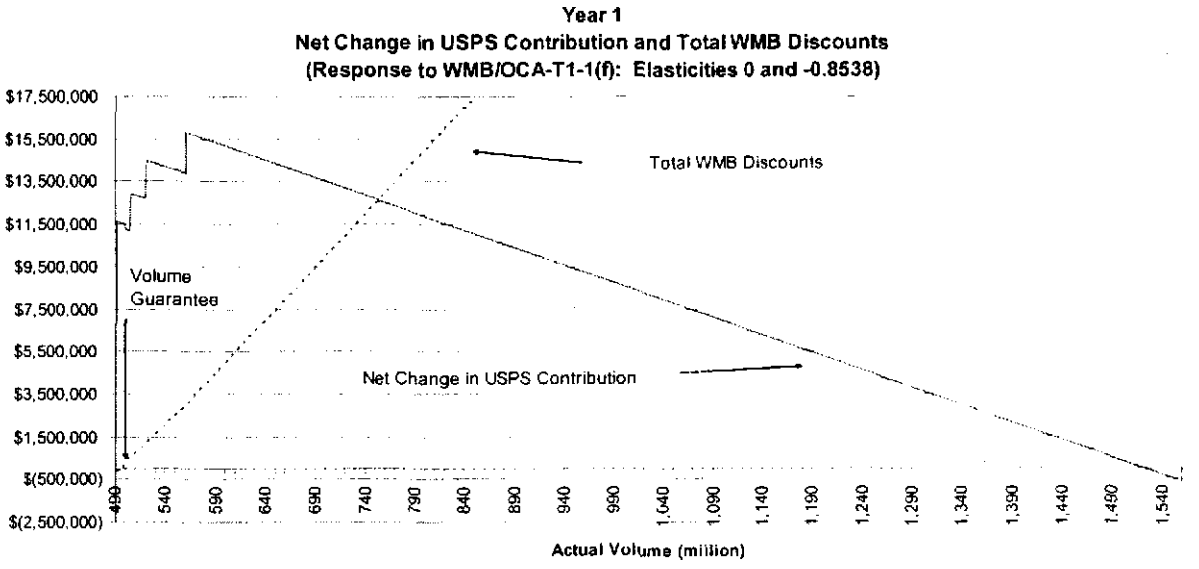
(c) Confirmed.

(d) Confirmed. Based upon the Panzar analysis using the average First-class Mail workshared letters own-price elasticity and the average price-discount elasticity, if Washington Mutual mails First-class Mail solicitation letters exceeding 585 million, **584** million, and **582** million in Years **1, 2,** and 3, respectively, the Postal Service will lose First-Class Mail contribution. See response to part (g), below.

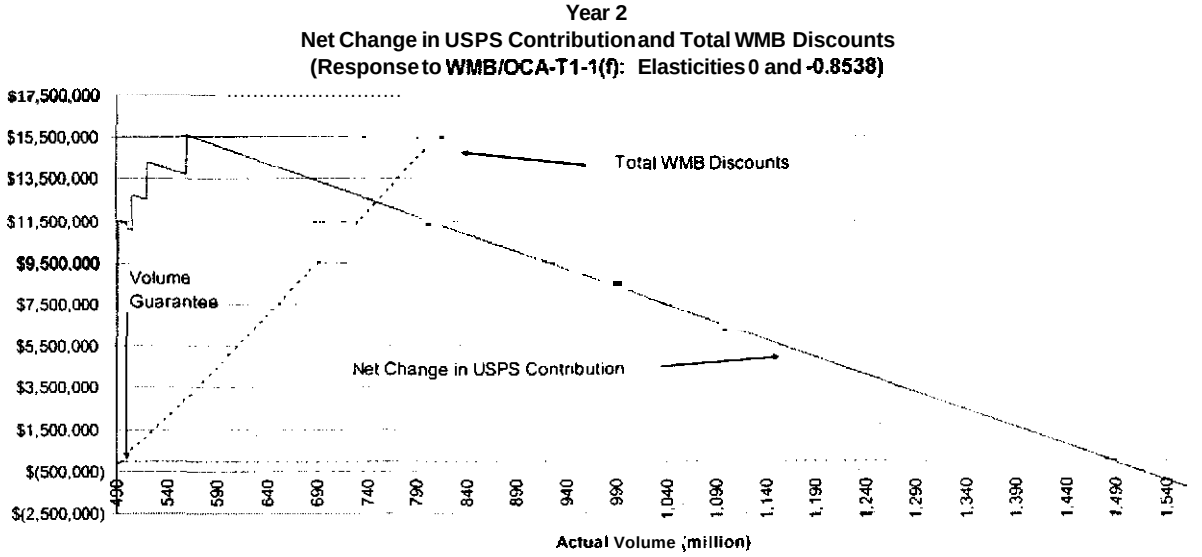
ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMB/OCA-TI-1-4

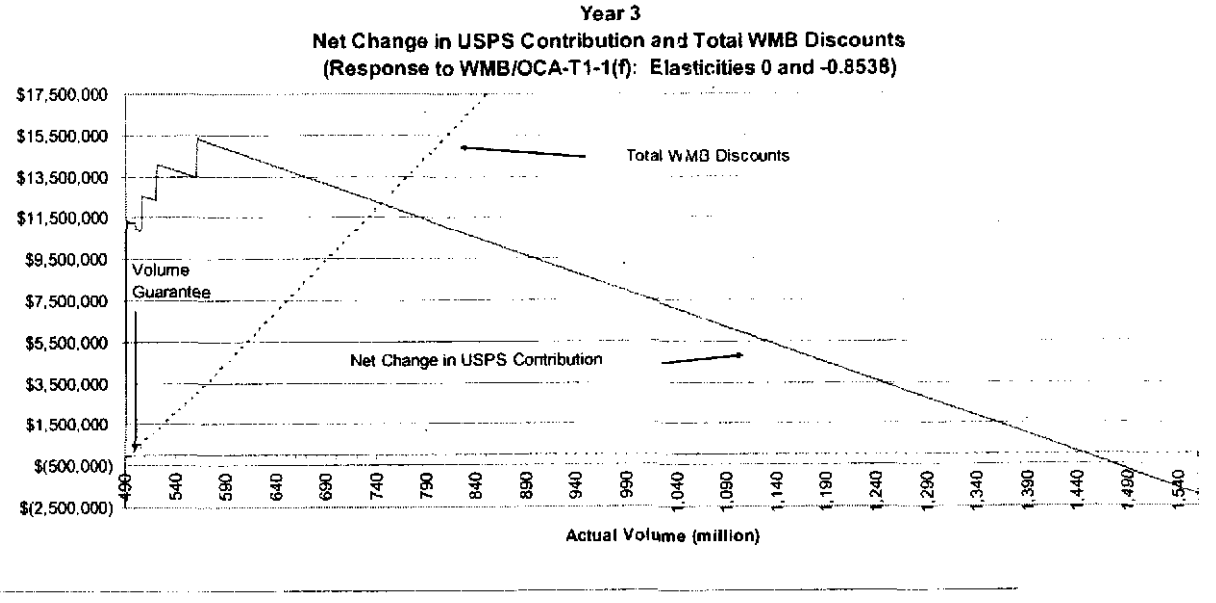
(e) Confirmed. The price-difference elasticity of -0.8538 **was** "backed-out" of Washington Mutual's stated before-rates and after-rates point volume estimates, using the average revenue for First-class marketing letters of $0.324, the Standard Mail revenue per piece of $0.204, and the highest negotiated discount of $0.050

(f) See charts, below, for Years 1, 2, and 3, obtained by inserting -0.8538 in Cell D11 of Excel file "OCA-T-1_Att1-WMB.xls," worksheet tab "Year 1."



ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMB/OCA-T1-1-4



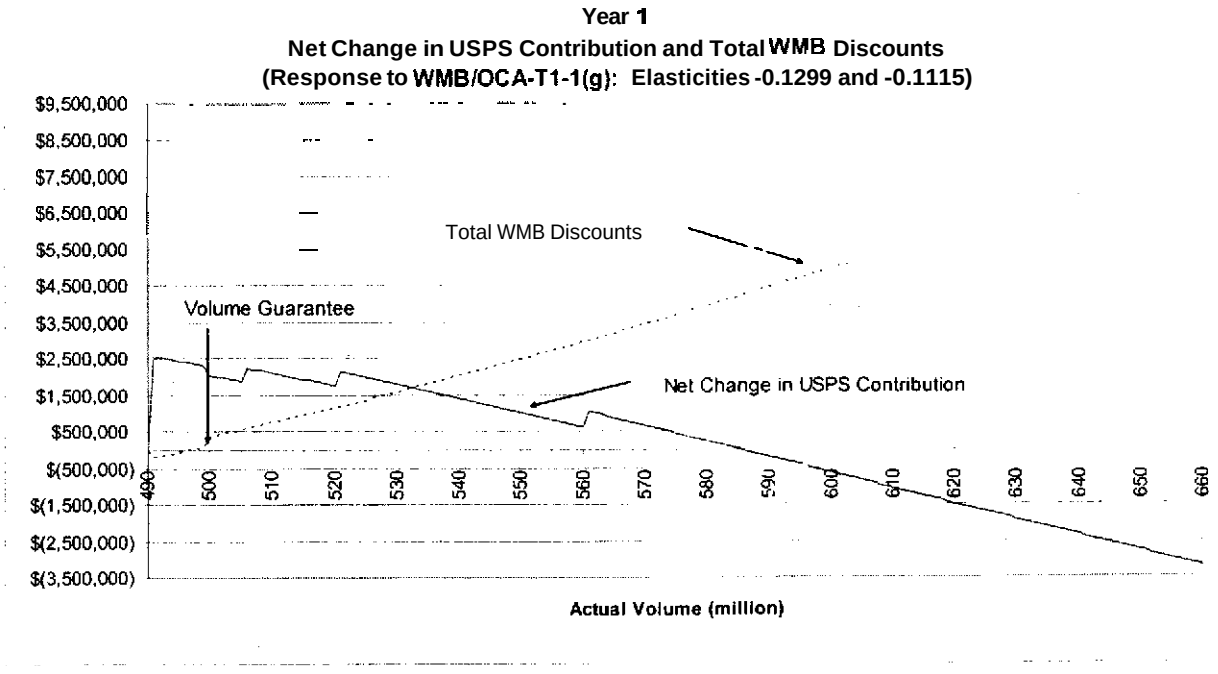


(g) See charts, below, **for** Years 1, 2, and 3, obtained by using *the* "Long-Run" own-price elasticity (-0.129934) for First-class workshared letters estimated by witness Thress (USPS-T-7), Table 16, in Docket No. R2006-1, and the average price-difference elasticity (-0.111483) in the following equation

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMBIOCA-T1-1-4

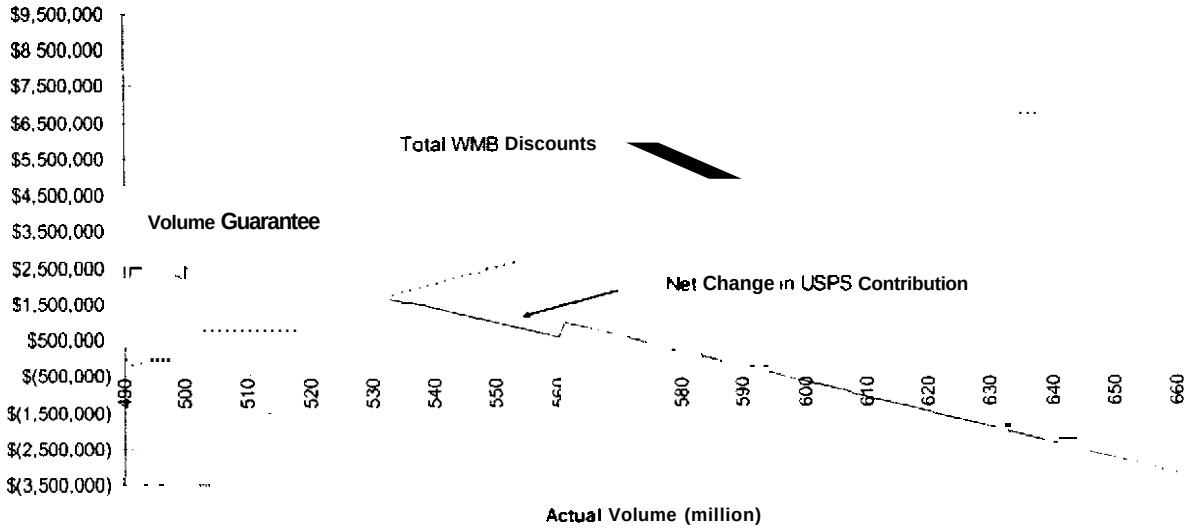
$$Q_0 = Q_1 \cdot \left(\frac{p_0}{p_d}\right)^{E_{p'}} \cdot \left(\frac{d_0}{d_d}\right)^{E_d}$$

where Q_0 is the before-rates Standard Mail volume, Q_1 is the forecast after-rates First-Class Mail volume, p_0 is the before-rates average First-class Mail marginal price, p_1 is the after-rates average marginal price, $E_{p'}$ is the average First-class workshared letters own-price elasticity, d_0 is the before-rates average marginal price difference between First-class Mail and Standard Mail, d_1 is the afler-rates average marginal difference, and E_d is the price-difference elasticity.

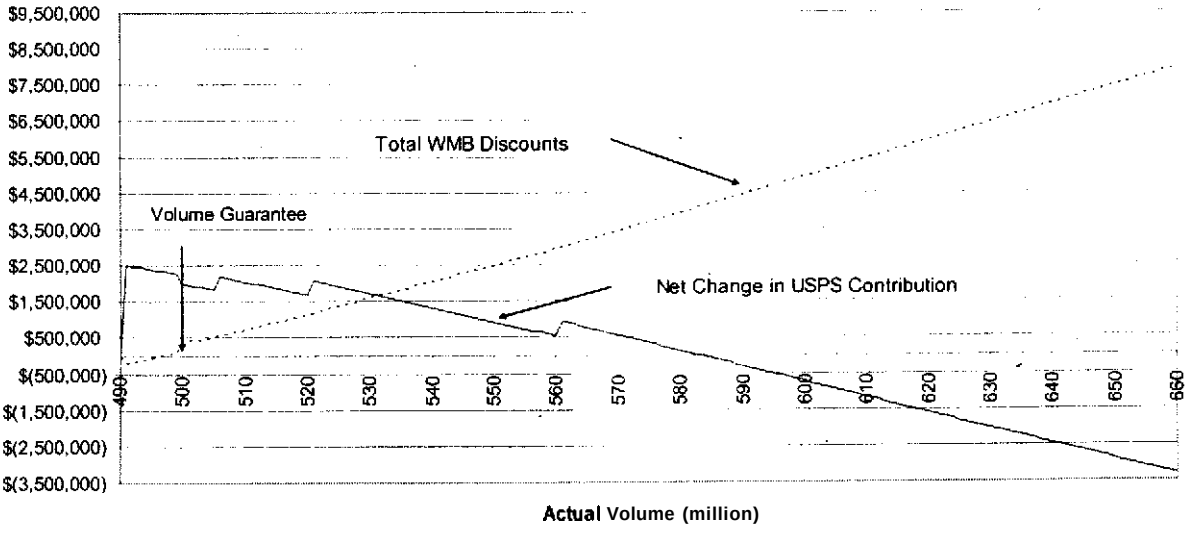


ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIESWMBIOCA-TI-1-4

Year 2
Net Change in USPS Contribution and Total WMB Discounts
(Response to WMB/OCA-T1-1(g): Elasticities -0 1299 and -0.1115)



Year 3
Net Change in USPS Contribution and Total WMB Discounts
(Response to WMB/OCA-T1-1(g): Elasticities -0.1299 and -0.1115)



ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMBIOCA-TI-1-4

WMBIOCA-TI-2.

Please refer to page 80 of the Commission's Docket No. MC2005-3 Opinion and Recommended Decision where it states, "the Panzar test does not tell the whole story here since it does not take into account the potential benefits from the conversion of flats to letters or the positive benefits from Bookspan's unique multiplier effect." Please also refer to page 31 of witness Ayub's testimony.

a) Please confirm that the Postal Service estimates that the WMB NSA will generate cost savings. If not confirmed, please explain fully.

b) Please confirm that the Panzar test "does not tell the whole story" in the WMB NSA because it does not take into account these cost savings. If not confirmed, please explain fully.

c) Please confirm that, in the Bookspan NSA, the Commission did, at least qualitatively, take into account potential benefits from the NSA that are not accounted for in the Panzar test. If not confirmed, please explain fully.

d) Please explain fully how you believe the cost savings from the WMB NSA should be taken into account.

RESPONSE TO WMBIOCA-TI-2

(a) Confirmed that the Washington Mutual NSA will generate a cost saving associated with providing electronic address correction notices in lieu of physical returns, according to the Postal Service. However, those cost savings are not included in the Postal Service's estimate of the financial value of the Washington Mutual agreement.

(b) Confirmed that neither the Panzar analysis nor the Postal Service's financial model "tell[s] the whole story" since neither model takes into account cost savings from the provision of electronic address correction notices in lieu of physical returns.

(c) Confirmed that the Commission qualitatively took into account the potential benefits of Bookspan's multiplier effect. In the absence of an estimate of the financial value of the multiplier effect, it is not possible to account for any potential benefits using the Panzar analysis. Assuming an estimate of the financial value of Bookspan's multiplier effect were available, that value could have been incorporated into the Panzar analysis as described in part (d), below.

(d) Consistent with the financial model of the Postal Service, I do not assume any cost savings from the provision of electronic address correction notices in lieu *of* physical returns in estimating the financial value of the Washington Mutual NSA using the Panzar analysis. However, those cost savings, estimated at $2.2 million, $2.4 million, and $2.7 million in Years 1, 2 and 3, respectively, could be incorporated into the Panzar analysis as follows. For any assumed actual after-rates volume, the estimated cost savings for each year would be added to the "Net USPS Benefits" (Column [3] in OCA-T-1, Attachment 1) associated with the assumed actual volume for that year to estimate total value (i.e., net revenue plus cost savings) to the Postal Service. For example, the estimate of total value to the Postal Service in Year 1 assuming an actual volume of 521 million would be $3,380,663, consisting of $1,180,663 in "Net USPS Benefit" and $2,200,000 in cost savings.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMB/OCA-T1-1-4

WMBIOCA-TI-3

Please refer to Table 1 on Page 25 of your testimony, which presents your analysis of the Net Present Value of the Washington Mutual NSA.

a) Has the Commission required the net contribution of previously approved NSAs to cover negotiation costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.

b) Has the Commission required the net contribution of previously approved NSAs to cover litigation costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.

c) Has the Commission required the net contribution of previously approved NSAs to cover administrative costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.

d) Has the Commission required the net contribution of previously approved niche classifications to cover litigation costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.

e) Has the Commission required the net contribution of previously approved niche classifications to cover administrative costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.

9 Are the administrative, litigation, and negotiation costs shown in Table 1 institutional costs or attributable costs according to USPS costing methods? Please explain your response fully.

g) Are the administrative, litigation, and negotiation costs shown in Table 1 institutional costs or attributable costs according to PRC costing methods? Please explain your response fully.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMB/OCA-T1-1-4

RESPONSE TO WMB/OCA-T1-3

(a) – (c) No. That said, one of the purposes *of* my testimony is to ask the Commission to determine whether the Washington Mutual agreement should produce a positive return on investment, using net present value analysis, considering the Postal Service's investment in negotiating and litigating the agreement, and the estimated annual administrative expenses.

(d) – (e) While the Commission has not specifically estimated the litigation or administrative costs associated with a niche classification, or required that those costs be covered by revenues generated from a previously approved niche classification, there is an essential difference between an NSA and a niche classification. For a niche (or any other) mail classification, the Commission sets rates sufficient to cover attributable costs ***and*** make a reasonable contributiori tc the Postal Service's institutional costs, which include litigation and administrative costs. The resulting cost coverage may cover all or part of these institutional costs associated with the niche classification. In any event, it is clear these costs are considered at least indirectly by the Commission in determining the appropriate cost coverage for the niche classification. In the case of NSAs, negotiation, litigation and administrative expenses are not considered at all because neither the Postal Service nor the Commission has established an appropriate "cost coverage," or specified a positive rate of return for NSAs.

(f) Under the Postal Service's costing methodology, negotiation, litigation, and administrative costs associated with an NSA would be considered incremental costs.

Consequently, the Postal Service's markup would be expected to cover volume variable as well as incremental costs.

(g) Under the Commission's costing methodology, negotiation, litigation, and administrative costs associated with an NSA would also be considered incremental costs. In setting rates, the Commission would be expected to add incremental costs to volume variable costs, for which an appropriate markup would be made.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMBIOCA-TI-1-4

WMBIOCA-TI-4

Please refer to footnote 44 on page 26. Please refer further to Tr. 2/184 where witness Ayub states, "I think [the penalty] is supposed to cover the transaction costs of pursuing the NSAs."

a) Is the cited statement from Mr. Ayub the entire basis of your estimate of litigation costs? If not, please explain fully the basis of your estimate

b) Please explain fully the basis of your assumption that the costs to negotiate an NSA are $250,000.

RESPONSE TO WMBIOCA-TI-4

(a) Yes.

(b) During discovery, I attempted to develop directly the Postal Service's costs related to the negotiation of the Washington Mutual NSA. As a result of the Postal Service's objection to my discovery request (see Objection of United States Postal Service to Interrogatory of the Office of Consumer Advocate to Witness Ayub (OCA/USPS-T1-28), July 10, 2006), however, I assumed negotiation costs of $250,000, based upon the work effort described in the testimony of witness Ayub, much of it occurring "[a]fter the commencement of negotiations with WMB." (Page 13). That work effort includes "extensive additional [Postal Service] research on the company using data from Postal Service systems and from publicly available sources." (Id.) The Postal Service work effort also involves considerable analysis "of a company's Before Rates forecasts," specifically analysis of volume trends, economic variables, account growth, and the company's response during negotiations, plus research and discussions with outside analysts. Moreover, the Postal Service's "process of

evaluating WMB's forecast is an iterative process that continues through the course of our NSA negotiations." (Page 14) In addition, once negotiations have concluded, the agreement "undergoes a rigorous internal review process at the Postal Service, including review by a cross functional group of managers and executives." (Page 14-15) These elements-extensive additional research considerable analysis, an iterative evaluation process, and rigorous management-executive review—formed the basis for my estimate.

RESPONSE OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORY WMB/OCA-T1-5

WMB/OCA-T1-5.

Please refer to your response to WMB/OCA-T1-2(d) where you explain how cost savings "could be incorporated into the Panzar analysis." Please also refer to your response to WMB/OCA-T1-1(f) where you provide a Panzar analysis using a price-difference elasticity of -.8538. Finally, please refer to Table 4 on page 9 of WMB-T-1, which shows after-rates First-class Mail volume forecasts of 713 million, 750 million, and 785 million pieces, respectively, for Year 1, 2, and 3 of the NSA. For the purpose of this interrogatory, please assume that WMB's own-price elasticity for First-class Mail is zero.

(a) Based upon a Panzar analysis that incorporates cost savings using the method described in your response to WMB/OCA-T1-2(d), what is the minimum price-difference elasticity that would result in a Year 1 USPS net benefit at an after-rates volume of 713 million First-class Mail pieces? Please provide all of your underlying calculations.

(b) Based upon a Panzar analysis that incorporates cost savings using the method described in your response to WMB/OCA-T1-2(d), what is the minimum price-difference elasticity that would result in a Year 2 USPS net benefit at an after-rates volume of 750 million First-class Mail pieces? Please provide all of your underlying calculations.

(c) Based upon a Panzar analysis that incorporates cost savings using the method described in your response to WMB/OCA-T1-2(d), what is the minimum price-difference elasticity that would result in a Year 3 USPS net benefit at an after-rates volume of 785 million First-class Mail pieces? Please provide all of your underlying calculations.

RESPONSE TO WMBIOCA-TI-5

The "minimum" price-difference elasticities requested are unrelated to, and can only be derived separately from, the cost savings estimated by the Postal Service. The estimated cost savings from the provision of electronic address correction notices are calculated from Postal Service costs of providing electronic versus physical returns and a subset of Washington Mutual's after-rates volumes. As described in my response to WMB/OCA-T1-2(d), the Postal Service's estimated cost savings "would be added to the

'Net USPS Benefits'," which is estimated separately using a price-difference elasticity in the Panzar analysis.

As requested, however, the "minimum" price-difference elasticities can be derived from Washington Mutual's before-rates and after-rates point volume estimates for each year, the average revenue per piece for First-class Mail marketing letters and Standard Mail letters, and the agreement's negotiated discounts. Assuming Washington Mutual's own-price elasticity for First-class Mail marketing letters is 0, the form of the equation is

$$Q_0 = Q_1 \cdot 1 \cdot \left(\frac{d_0}{d_d}\right)^{E_d}$$

where E_d is the price-difference elasticity, Q_0 and Q_1 are Washington Mutual's before-rates (450, 475, and 500 million) and after-rates (713, 750, and 785 million) point volume estimates, respectively, for each year, d_0 is the before-rates average marginal price difference between First-class Mail marketing letters and Standard Mail letters ($0.346 - $0.206), and d_d is the after-rates marginal price difference at the highest negotiated discount ($0.346 - $0.206 - $0.050), as provided in the testimony of witness Ayub (USPS-T-I), Appendix 1, Page 10, revised June 7,2006.

The "minimum" price-difference (i.e., "discount") elasticity, E_d, the only unknown, can then be "backed-out" of the equation above by solving the following:

$$\ln Q_0 = \ln Q_1 + E_d \cdot \ln\left(\frac{d_0}{d_d}\right)$$

RESPONSE OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORY WMB/OCA-T1-5

The "minimum" price-difference elasticities for each year, calculated in the attachment to this response, are presented below.

(a) Year 1: -1.0437

(b) Year 2: -1.0358

(c) Year 3: -1.0230

Attachment to the Response to WMB/OCA-T1-5(a) - (c)

"Price-Difference" (i.e., "Discount") Elasticity,
per USPS-T-1 (Ayub), Appendix A,
Page 10 (Rev 6-7-06)

			Year 1	Log (ln)	Year 2	Log (ln)	Year 3	Log (ln)
[1]	WMB BR Volume	O_o	450	6.1092476	475	6.1633149	500	6.2146082
[2]	WMB AR Volume	O_1	713	6.5694815	750	6.6200733	785	6.6656838
[3]	Ave Rev FCM Mkt Ltrs/pc		$0.346		$0.346		$0.346	
[4]	Std Rev/pc		$0.206		$0.206		$0.206	
[5]	BR Ave Price Difference, FCM - Std Mail	d_o	$0.140		$0.140		$0.140	
[6]	Discount (last tier)		$0.050		$0.050		$0.050	
[7]	AR Marginal Price Difference	d_1	$0.090		$0.090		$0.090	
[8]	Ratio BR / AR Price Difference		1.554189	0.440954	1.554189	0.440954	1.554189	0.440954
[9]	Natural Log			2.7183		2.7183		2.7183
	"Discount" Elasticity	E_d	-1.0437		-1.0358		-1.0230	

Sources:

[1] USPS-T-1, App A, Pg 2
[2] USPS-T-1, App A, Pg 2
[3] USPS-T-1, App A, Pg 10 (REV 6-7-06) unrounded
[4] USPS-T-1, App A, Pg 10 (REV 6-7-06) unrounded
[5] [3] - [4]
[6] USPS-T-1, App A, Pg 7
[7] [5] - [6]
[8] [5] / [7]
[9] Natural Log

RESPONSE OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORY WMB/OCA-T1-6

WMB/OCA-T1-6.

Please refer to the charts you provided in response to WMB/OCA-T1-1(f), which show that, assuming an own-piece elasticity of zero and a price-difference elasticity of -0.8538 and ignoring the NSAs cost savings, the NSA will generate a significant net change in USPS contribution in each year at WMB's After Rates volume forecasts.

Please also refer to interrogatory WMBIOCA-T1-5 and your response to it. Albeit in different words, WMB/OCA-T1-5 asked you how large WMB's price-difference elasticity would need to be for the NSA to generate a positive net change in USPS contribution each year at WMB's After Rates volume forecasts (713 million in Year 1, 750 million in Year 2, and 785 million in Year 3). You responded to this interrogatory by providing estimates of the price-difference elasticities implied by WMB's Before-Rates and After-Rates volume forecasts if one makes the additional assumption that WMB's own-price elasticity is zero.

Assuming that WMB's own-price elasticity is zero, how iarge, according to a Panzar Analysis, must the price-difference elasticity be for the NSA to produce a positive USPS net change in USPS contribution at WMB's After-Rates volume forecasts? Please provide your underlying calculations. If you are unabie to incorporate the NSAs cost savings into the "Panzar Analysis," please indicate that this is so and ignore the NSA's cost savings in performing the Panzar Analysis.

RESPONSE TO WMB/OCA-T1-6

I interpret this interrogatory to request calculation of a price-difference elasticity assuming Washington Mutual enters First-class Mail solicitation letter volume that generates discounts equal to the estimated return cost savings of $2.2 million, $2.4 million, and $2.7 million at the stated after-rates volume of 713 million, 750 million, and 785 million, respectively, in Years 1, 2, and 3 of the agreement.

The following information is known: Washington Mutual's after-rates (i.e., 713 million, 750 million, and 785 million) volume estimate fcr each year, the average revenue per piece for First-class Mail solicitation letters (i.e., $0.346) and Standard Mail letters (i.e., $0.206), and the relevant negotiated discount (i.e., $0.035, $0.040, $0.045,

RESPONSE OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORY WMB/OCA-T1-6

or $0.050). In the absence of a stated before-rates volume, however, a new before-rates volume must be calculated for each year of the agreement

At the third declining block discount ($0.045) tier, solicitation letter volume of 54 million, 58 million, and 65 million generate discounts equal to $2.2 million, $2.4 million, and $2.7 million, respectively, during Years 1, 2, and 3 of the agreement. This implies a new before-rates volume (or initial discount threshold volume) of 659 million (713 million – 54 million), 692 million (750 million – 58 million), and 720 million (785 million – 65 million) in Years 1, 2, and 3, respectively.

Given the above information, and assuming Washington Mutual's own-price elasticity for First-class Mail marketing letters is 0, the form of the equation is

$$Q_0 = Q_1 \cdot 1 \cdot \left(\frac{d_0}{d_d}\right)^{E_d}$$

where E_d is the price-difference elasticity, Q_0 and Q_1 are the new before-rates (659, 692, and 720 million) and previously provided after-rates (713, 750, and 785 million) volume estimates, respectively, for each year, d_0 is the before-rates average marginal price difference between First-class Mail marketing letters and Standard Mail letters ($0.346 - $0.206), and d_1 is the after-rates marginal price difference at the relevant negotiated discount ($0.346 - $0.206 - $0.045).

The price-difference (i.e., "discount") elasticity, E_d, the only unknown, can then be "backed-out" of the equation above by solving the following:

$$\ln Q_0 = \ln Q_1 + E_d \cdot \ln\left(\frac{d_0}{d_d}\right)$$

RESPONSE OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORY WMB/OCA-T1-6

The price-difference elasticities for each year, calculated in the attachment to this response at page 2, are presented the table below.

YEAR 1		YEAR 2		YEAR 3	
AR Volume	Elasticity	AR Volume	Elasticity	AR Volume	Elasticity
713 Million	-0.2035	750 Million	-0.2080	785 Million	-0.2233

It should be noted that the calculations presented above are not the Panzar analysis developed in my testimony, which estimates the increase or decrease in institutional contribution at each after-rates volume. Rather, the above calculations represent a variation of the "suggested framework developed by the Commission in PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), paras. 5001-5038. Washington Mutual's variation is the suggested use of its after-rates volumes to estimate a new before-rates volume — representing the difference between the after-rates volume and a volume that generates discounts equal to the return cost savings — and then calculating the resulting price-difference elasticity to judge whether the new before-rates volume is reasonable or not. As stated by the Commission:

> The Panzar analysis is not to be confused with the alternative approach model for designing declining block NSAs suggested by the Commission in its Opinion and Further Recommended Decision in MC2003-4, paras. 5001-38. The former is an analysis for evaluating the risk of loss, while the latter is a model for negotiating NSAs that uses the Panzar analysis in their design.

PRC Op. MC2005-3 (Bookspan), para. 4089, fn 110

Attachment to the Response to WMB/OCA-T1-6
Page 1

Year 1			Year 2			Year 3		
Threshold		Discount	Threshold		Discount	Threshold		Discount
659,000,000	674,000,000	$ 0.035	692,000,000	707,000,000	$ 0.035	723,000,000	738,000,000	$ 0.035
674,000,000	689,000,000	$ 0.040	707,000,000	722,000,000	$ 0.040	738,000,000	753,000,000	$ 0.040
689,000,000	713,000,000	$ 0.045	722,000,000	750,000,000	$ 0.045	753,000,000	785,000,000	$ 0.045
		$ 0.050		-	$ 0.050		-	$ 0.050
-		$ 0.050	-	-	$ 0.050	-	-	$ 0.050
-		$ 0.050	-		$ 0.050	-		$ 0.055

Calculation of Discount Volume Where Discounts Equal Return Cost Savings

Return Cost Savings	**Year 1**	**Year 2**	**Year 3**
[1] Cost Saving	**$ 2,200,000**	**$ 2,400,000**	**$ 2,700,000**
Discounts Earned			
[2] First tier ($0.035)	$ 525,000	$ 525,000	$ 525,000
[3] Second tier ($0.040	$ 600,000	$ 600,000	$ 600,000
[4] Third tier ($0.045)	$ 1,075,000	$ 1,275,000	$ 1,575,000
[5] **Discounts**	**$ 2,200,000**	**$ 2,400,000**	**$ 2,700,000**
Discount Volume			
[6] First tier	15,000,000	15,000,000	15,000,000
[7] Second tier	15,000,000	15,000,000	15,000,000
[8] Third tier	23,888,889	28,333,333	35,000,000
[9] **Volume**	**53,888,889**	**58,333,333**	**65,000,000**
[10] **Rounded**	**54,000,000**	**58,000,000**	**65,000,000**

Notes and Sources:
[1] USPS-T-1, at 31
[2] [6] * $0.035
[3] [7] * $0.040
[4] [1] - ([2] + [3])
[5] [2] + [3] + [4]
[6] 674,000,000 - 659,000,000; 707,000,000 - 692,000,000; 738,000,000 - 723,000,000
[7] 689,000,000 - 674,000,000; 722,000,000 - 707,000,000; 753,000,000 - 738,000,000
[8] [4] / $0.045
[9] [6] + [7] + [8]
[10] [9] Rounded to nearest million.

"Price-Difference" (i.e., "Discount") Elasticity

			Year 1		Year 2		Year 3	
				Log (ln)		Log (ln)		Log (ln)
[1]	New WMB BR Volume	Q_o	659	6.4907236	692	6.539586	720	6.5792513
[2]	WMB AR Volume	Q_1	713	6.5694815	750	6.6200733	785	6.6656838
[3]	Ave Rev FCM Mkt Ltrs/pc		$0.346		$0.346		$0.346	
[4]	Std Rev/pc		$0.206		$0.206		$0.206	
[5]	BR Ave Price Difference, FCM - Std Mail	d_o	$0.140		$0.140		$0.140	
[6]	Discount (third tier)		$0.045		$0.045		$0.045	
[7]	AR Marginal Price Difference	d_1	$0.095		$0.095		$0.095	
[8]	Ratio BR / AR Price Difference		1.4725804	0.3870162	1.47258	0.3870162	1.47258	0.3870162
[9]	Natural Log			2.7183		2.7183		2.7183
	"Discount" Elasticity	E_d	-0.2035		-0.2080		-0.2233	

Sources:
[1] "Volumes" Worksheet, Line [10]
[2] USPS-T-1, App A, Pg [illegible]
[3] USPS-T-1, App A, Pg [illegible]0 (REV6-7&6) unrounded
[4] USPS-T-1, App A, Pg [illegible]0 (REV6-7&6) unrounded
[5] [3] - [4]
[6] USPS-T-1, App A, Pg [illegible]
[7] [5] - [6]
[8] [5] / [7]
[9] Natural Log